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CORPORATE LAW

LEVEL OF CONDUCT ACTIONABLE UNDER THE SOUTH CAROLINA BUSINESS JUDGMENT RULE

A common-law principle of corporate jurisprudence for more than 165 years,[1] the business judgment rule precludes judicial review of the wisdom or soundness of directors' carefully exercised business decisions[2] and further ensures that directors will not be held liable for "an honest mistake of business judgment."[3] Dispute exists, however, regarding what level of conduct remains actionable in light of the business judgment rule. The South Carolina Supreme Court in *Dockside Ass'n v. Detyens*[4] held that "the business judgment rule precludes judicial review of actions taken by a corporate governing board absent a showing of a lack of good faith, fraud, self-dealing or unconscionable conduct."[5] The language of the South Carolina Court of Appeals in the more recent case of *Goddard v. Fairways Development General Partnership*,[6] however, implies that ordinary negligence is the applicable standard.[7] This note attempts to resolve the issue by examining prior applications of the rule in South Carolina courts.

South Carolina law provides a specific formulation of a director's fiduciary duties to both the corporation and its shareholders.[8] Utilizing a

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1. *See* Percy v. Millaudon, 8 Mart. (n.s.) 68, 78 (La. 1829) (stating that liability is imposed on directors only when "the error of the agent is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it"); *see, e.g.*, Godbold v. Branch Bank, 11 Ala. 191, 201 (1847) (holding directors of a bank not liable if "they acted in good faith, and with a view to the promotion of the interest of the bank"); Bodell v. General Gas & Elec. Corp., 140 A. 264, 267 (Del. 1927) (holding that "the discretion of a board of directors . . . should not be interfered with, except for fraud, actual or constructive, such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the rights of its stockholders"); Hodges v. New England Screw Co., 1 R.I. 312, 338 (1850) (stating that the general rule "is that a director is liable only for ordinary care and prudence").

2. 2 SHERWOOD M. CLEVELAND ET AL., S.C. CORPORATE PRACTICE MANUAL § 24.09(2)(c) (1989); *see also* ROBERT C. CLARK, CORPORATE LAW § 3.4 (1986); HARRY G. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 234 (2d ed. 1970).

3. *Bodell*, 140 A. at 267.

4. 294 S.C. 86, 362 S.E.2d 874 (1987).

5. *Id.* at 87, 362 S.E.2d at 874 (citing Papalexiou v. Tower West Condominium, 401 A.2d 280, 285-86 (N.J. Super. Ct. Ch. Div. 1979)).

6. 310 S.C. 408, 426 S.E.2d 828 (Ct. App. 1993).

7. *See id.* at 414, 426 S.E.2d at 832 (holding that "the conduct of the directors should be judged by the 'business judgment rule' and absent a showing of bad faith, dishonesty or incompetence, the judgment of the directors will not be set aside by judicial action.").

8. *See* S.C. CODE ANN. § 33-8-300(a) (Law. Co-op. 1990) (providing that a "director shall discharge his duties . . . (1) in good faith; (2) with the care an ordinarily prudent person in a like

"traditional standard"[9] dating to the nineteenth century,[10] general statutory language dictates "the manner in which the director performs his duties."[11] A director may breach this general standard of care by disregarding fundamental duties or by being inattentive.[12] Only when a director makes a conscious decision, however, is application of the business judgment rule triggered. Section 33-8-300 is not an attempt "to codify the business judgment rule;"[13] rather, it is a broad statutory enactment that "leaves many questions open for judicial resolution."[14] Armed with the authority to fill in the gaps of a broad statutory section with common-law principles relating to fiduciary duties,[15] the courts of South Carolina discussed the business judgment of the directors in both *Dockside* and *Goddard*.

In *Dockside* the board of directors of a non-profit homeowners' association declared that an emergency situation existed and levied an assessment against the co-owners of the property.[16] The association's bylaws required approval of sixty percent of the co-owners for assessments made to the common elements of the property, "while . . . [assessments] made for emergency expenditures require[d] approval by 51 per cent."[17] When Detyens and another co-owner, Burbic, "refused to pay the special assessment because less than 60 per cent of the co-owners approved it,"[18] the homeowners association brought an action to foreclose liens for the unpaid amount.

In upholding the association's determination that an emergency situation existed, the court of appeals relied on *Papalexiou v. Tower West Condominium*,[19] a factually similar case. In *Papalexiou* a majority of the board of

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position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation and its shareholders").

9. E. Norman Veasey & Julie M.S. Seitz, *The Business Judgment Rule in the Revised Model Act, the* Trans Union *Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1493 (1985).

10. *See* Briggs v. Spaulding, 141 U.S. 132, 152 (1891) (determining that bank directors must act as "ordinarily prudent and diligent men . . . under similar circumstances, and in determining that . . . the usages of business should be taken into account").

11. S.C. CODE ANN. § 33-8-300 official comment (Law. Co-op. 1990).

12. *See, e.g.*, Olin Mathieson Chem. Corp. v. Planters Corp., 236 S.C. 318, 114 S.E.2d 321 (1960) (finding directors liable for inattention and for negligent supervision of officers); Baker v. Mutual Loan & Inv. Co., 213 S.C. 558, 50 S.E.2d 692 (1948) (finding directors liable for wrongful payment of dividends resulting from inattentiveness).

13. S.C. CODE ANN. § 33-8-300 official comment (Law. Co-op. 1990).

14. 2 CLEVELAND, *supra* note 2, § 24.09(2)(a).

15. *See id.*

16. Dockside Ass'n v. Detyens, 291 S.C. 214, 215, 352 S.E.2d 714, 715 (Ct. App.), *aff'd*, 294 S.C. 86, 362 S.E.2d 874 (1987).

17. *Id.*

18. *Id.*

19. 401 A.2d 280 (N.J. Super. Ct. Ch. Div. 1979).

trustees of a condominium association determined that a financial emergency existed and levied a $100,000 assessment against the condominium owners. The bylaws prohibited the board of trustees from spending more than $5000 without approval of a majority of the owners unless an emergency existed. The plaintiffs, several unit owners, argued that an emergency did not exist and that the assessment was therefore invalid because the board did not obtain the approval of a majority of the owners.[20] In upholding the board's determination, the New Jersey court stated that "[c]ourts will not second-guess the actions of directors unless it appears that they are the result of fraud, dishonesty or incompetence."[21] The South Carolina Court of Appeals adopted this logic.[22]

In *Goddard*,[23] the owners of four units in a planned unit development (PUD) brought an action against the developer and the homeowners' association to dissolve the development. A "Declarations of Covenants, Conditions and Restrictions" (Declarations) governed the PUD. The Declarations called for mandatory membership in the association by each villa owner and required the homeowners' association to own and maintain the common areas of the development. Furthermore, the Declarations required the consent of 90% of the villa owners for amendment and the consent of 100% of the villa owners for dissolution.[24] The PUD gave superior voting rights to the developer,[25] who determined that assessments should be made against lots, not parcels; therefore, only the six owners paid assessments, and these funds were "inadequate to maintain the common areas."[26] The plaintiffs proposed that the developer pay assessments according to its voting power or that the PUD be dissolved and title to the common areas be transferred to the owners. The developer refused to pay assessments other than on the one lot it owned, and the plaintiffs could not force the PUD's dissolution because of the unanimous-vote requirement.[27] The court of appeals referred to its own opinion in *Dockside* and stated: "We cannot say that under the circumstances

20. *Id.* at 282-83.

21. *Id.* at 286.

22. *Dockside*, 291 S.C. at 217, 352 S.E.2d at 716.

23. 310 S.C. 408, 426 S.E.2d 828 (Ct. App. 1993).

24. *Id.* at 410, 426 S.E.2d at 830.

25. Note 1 of the court's opinion states:

> Article III of the Declarations creates two classes of voting rights in the Association. Class "A" is all "Owners" except the Developer; they have one vote for each "Lot" owned. Class "B" is the Developer; it has 50 votes for each "Lot" owned, and a total of 1500 votes for the existing "Parcels." As each "Parcel" is subdivided, the Developer receives 50 votes for each resulting "Lot." This class system continues until the number of Class A votes equals the number of Class B votes.

Id. at 410 n.1, 426 S.E.2d at 830 n.1.

26. *Id.* at 411, 426 S.E.2d at 830.

27. *Id.*

of this case the [defendants] violated a fiduciary duty to the [plaintiffs] by not voting for higher assessments."[28]

Considering *Dockside* and *Goddard* did not actually penetrate the issue, the question remains: What level of conduct is actionable under the business judgment rule in South Carolina? In at least one instance,[29] the South Carolina Supreme Court has been willing to look to the case law of Delaware, "the Mother Court of corporate law,"[30] for guidance in the area of corporate jurisprudence. The Delaware and the South Carolina versions of the business judgment rule are similar in substance, and both contain duties of loyalty and care.[31] Because a South Carolina court would probably look to Delaware case law again for guidance, a summary of the relevant law concerning the business judgment rule in Delaware is appropriate.

In *Aronson v. Lewis*[32] plaintiff Lewis brought a shareholder derivative suit against Meyers Parking System and its board of directors. Lewis alleged that certain transactions between the board and one of its directors, Fink, were improper and were only approved because Fink "personally selected each director and officer of Meyers."[33] At issue was an employment contract that Lewis claimed wasted corporate assets, had no valid business purpose, and was grossly excessive.[34] In granting the defendants' motion to dismiss, the court defined the business judgment rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[35] The court went on to state that to take advantage of the rule, directors "have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them."[36] Basing its definition of requisite care "upon concepts of gross negligence," the court explained further that, once directors have adequately informed themselves, they must "act with requisite care in the discharge of their

28. *Id.* at 414, 426 S.E.2d at 832.

29. Santee Oil Co. v. Cox, 265 S.C. 270, 217 S.E.2d 789 (1975).

30. Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1343 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991).

31. *Compare* S.C. CODE ANN. § 33-8-300(a) (Law. Co-op. 1990), *with* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

32. 473 A.2d 805 (Del. 1984).

33. *Id.* at 808.

34. *See id.* at 809. The contract at issue paid Fink $150,000 per year plus five per cent of net profits above a stated amount. When Fink retired, the contract required him to become a consultant, with payment of $150,000 for the first three years, $125,000 for the next three years, and $100,000 each year thereafter for life. The board also approved interest-free loans totaling $225,000 to Fink. At the time of the contract, Fink was seventy-five years old. *Id.* at 808-09.

35. *Id.* at 812.

36. *Id.*

duties."[37] The *Aronson* court noted that although the courts of Delaware had not precisely identified a director's standard of liability, precedents pointed towards a standard "less exacting than simple negligence."[38]

The very next year the Delaware Supreme Court handed down a much-criticized[39] decision in *Smith v. Van Gorkom*.[40] In *Van Gorkom*, the chief executive officer and chairman of Trans Union Corporation, Jerome Van Gorkom, privately negotiated a $55-per-share, cash-out merger with Jay Pritzker of the Marmon Group. For the offer to remain open, however, Pritzker demanded that Trans Union's board of directors "act on his merger proposal within the next three days."[41] The next day Van Gorkom called a special meeting of the board[42] and made a twenty-minute presentation of Pritzker's offer that included neither a valuation study nor physical merger documents for the board to review.[43] Based upon Van Gorkom's presentation, the representations of Trans Union's president and its chief financial officer, and the advice of outside counsel, the board approved the merger. At the next board meeting some two weeks later, the directors blindly approved amendments made to Pritzker's offer. Two and one-half months later, the board met and gave its final approval to the cash-out merger first proposed by Van Gorkom.[44]

The trial court in *Van Gorkom* upheld the board's actions, finding that the board had sufficient time between Van Gorkom's initial presentation and the board's approval some three months later to acquire "sufficient information to reach an informed business judgment on the cash-out merger proposal."[45] The supreme court, however, reversed and found the directors personally liable. The court focused on the process the board undertook in reaching its decision and held that the board's decision was not an informed business judgment. The court further held that the board's efforts to amend the

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37. *Id.*

38. *Id.* at 812 n.6.

39. *See* Smith v. Van Gorkom, 488 A.2d 858, 894 (Del. 1985) (McNeilly, J., dissenting) (calling the majority's opinion a "comedy of errors"); Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1455 (1985) (calling the case "one of the worst decisions in the history of corporate law"); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 1 (1985) ("The Delaware Supreme Court in *Van Gorkom* exploded a bomb.").

40. 488 A.2d 858 (Del. 1985).

41. *Id.* at 867.

42. The directors had one day's notice of the meeting and were not told its purpose. Only Trans Union's controller (Peterson) and its president and chief operating officer (Chelberg) knew the meeting's purpose. Moreover, Trans Union's investment banker, Salomon Brothers, was not invited. *Id.*

43. *Id.* at 867-68.

44. *Id.* at 869-70.

45. *Id.* at 870-71.

agreement were ineffectual and that the board did not deal with the stockholders in a frank and forthright manner.[46] The *Van Gorkom* court stated that fulfillment of a director's duty "requires more than the mere absence of bad faith or fraud."[47] Reaffirming its holding in *Aronson*, the court stated that "the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[48]

Despite the outrage of some commentators at the result reached in *Van Gorkom*,[49] a South Carolina court faced with the same set of facts found by the Delaware court would probably reach a comparable result. The *Van Gorkom* court merely held that, as fiduciaries, directors must inform themselves, "'prior to making a business decision, of all material information reasonably available to them.'"[50] This duty to become informed is not expressly stated in South Carolina's formulation of a director's duty of care; however, such a duty has been implied by the South Carolina Supreme Court in at least one instance.[51]

In response to the Delaware Supreme Court's decision in *Van Gorkom*, the Delaware Legislature in 1986 enacted a statute that authorizes stockholders to adopt charter provisions that limit the liability of directors to the corporation or its stockholders.[52] In 1988 the South Carolina General Assembly followed Delaware's initiative and enacted a similar measure.[53] This section may negatively imply that, absent any provision to the contrary in a corporation's articles, "the usual standard for liability in South Carolina is ordinary negligence";[54] however, this does not appear to be the case. Provisions

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46. *Id.* at 864.

47. *Id.* at 872.

48. *Id.* at 873.

49. *See supra* note 39 and accompanying text.

50. *Van Gorkom*, 488 A.2d at 872 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

51. Baker v. Mutual Loan & Inv. Co., 213 S.C. 558, 50 S.E.2d 692 (1948). Here, the court stated that the directors of an investment company had a "duty to inform themselves of the condition of the company which could not be discharged by shutting their eyes and blindly relying on any statement made by" someone who was neither a director nor an officer of the corporation. *Id.* at 566, 50 S.E.2d at 695. *But see* S.C. CODE ANN. § 33-8-300(b) (Law. Co-op. 1990).

52. Although specifically preventing a limitation of liability for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law," this section allows a corporation to include in its articles of incorporation a provision that eliminates or limits the personal liability of a director to the corporation or its stockholders for a director's breach of his fiduciary duties. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (Supp. 1994).

53. *See* S.C. CODE ANN. § 33-2-102(e) (Law. Co-op. 1990). This section, however, does not allow the articles of incorporation to include a provision that limits a director's liability for "acts or omissions . . . which involve gross negligence." S.C. CODE ANN. § 33-2-102(e)(ii) (Law. Co-op. 1990).

54. 2 CLEVELAND, *supra* note 2, at § 24.09(3).

placed in a corporation's articles of incorporation pursuant to similar director protection statutes "are now common in corporate affairs."[55] Furthermore, these same provisions undeniably "shield directors from breaches of the duty of care."[56] Cases applying the business judgment rule since the enactment of section 102(b)(7) in Delaware have continued to apply a gross negligence standard.[57]

Thus, *Aronson* remains the law in Delaware: "[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence."[58] Perhaps adding clarity to the rule, another Delaware court has stated: "In the corporate context, gross negligence means 'reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason.'"[59] The courts of South Carolina have relied on Delaware for guidance concerning corporate matters in the past. Furthermore, both states have similar attitudes concerning the limited liability of directors, and both states have similarly construed the nature of directors' fiduciary duties to a corporation and its shareholders. Application of the business judgment rule in South Carolina, therefore, should be no different.

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55. Stroud v. Grace, 1990 WL 176803, at *8 (Del. Ch. Nov. 1, 1990), *aff'd in part and rev'd in part on other grounds*, 606 A.2d 75 (Del. 1992).

56. Zirn v. VLI Corp., 621 A.2d 773, 783 (Del. 1993).

57. *See In re* Sea-Land Corp. Shareholders Litig., 642 A.2d 792 (Del. Ch.), *aff'd sub nom.* Sea-Land Corp. Shareholder Litig. v. Abely, 633 A.2d 371 (Del. 1993) (citing *Van Gorkom* and holding that in a corporate acquisition context "[t]he standard for determining whether a board decision was sufficiently informed is gross negligence"); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989) (quoting *Van Gorkom*, 488 A.2d at 873, for the proposition that "[t]he standard for determining 'whether a business judgment reached by a board of directors was an informed one' is gross negligence"); Jardel Co. v. Hughes, 523 A.2d 518 (Del. 1987). *Jardel* was a civil suit by a mall employee against the mall's owner alleging failure to provide adequate security. *Id.* at 521-22. The court cited *Aronson* and stated that "[t]he concept of gross negligence continues to find application as a recovery threshold in cases of corporate director liability under the business judgment rule." *Id.* at 530.

58. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). *See also* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) ("To determine whether a business judgment reached by a board of directors was an informed one, we determine whether the directors were grossly negligent."); E. Norman Veasey & William E. Manning, *Codified Standard-Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 928 (1980) ("The language of other Delaware cases supports the conclusion that the Delaware standard is gross negligence.").

59. Tomczak v. Morton Thiokol, Inc., 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) (quoting Gimbel v. Signal Cos., 316 A.2d 599, 615 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974); Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929)).